April 30, 2012

Jennifer J. Johnson
Secretary
Board of Governor's of the Federal Reserve System
20th St. and Constitution Ave NW
Washington, DC 20551

Re: Regulation YY; Docket No. 1438, RIN 7100: Enhanced Prudential Standards and Early Remediation Requirements for Covered Companies

Dear Ms. Johnson,

In general the Proposed Rule effectively implements the Statute. The stress testing methodology is commendable. And the 10% single counterparty credit limit between covered companies larger than $500 billion is applauded. This is one of the strongest safeguards of the Proposed Rule and I encourage that it remains intact in the Final Rule.

However, the draft falls short of using the full range of tools that the Statute permits. For instance, I think that the Board should use the authority to produce enhanced public disclosures of stress tests. Also, the Statute gives the Board the authority to place short-term debt limits on covered companies. Among the many lessons we can take away from this crisis, and many others, is that firms failed because of maturity mismatches resulting from excessive use of short-term financing schemes, so it seems that short-term debt limits could prove useful in preventing the build up of fatal mismatches.

ANSWERS TO SPECIFIC QUESTIONS

Question 12: The Dodd-Frank Act contemplates additional enhanced prudential standards, including a limit on short-term debt. Should the Board adopt a short-term debt limit in addition to or in place of the LCR and NSFR? Discuss why or why not?

Given how prevalent overnight repos still are at many financial institutions, and given that the problem of "too interconnected to fail" is exacerbated when too many financial institutions rely on one another for overnight repo to finance their institutions, it would be prudent for the Board to include a limit on short-term debt in addition to the LCR and NSFR.

The Board's inclusion of a 10% cap on single-counterparty credit limit for credit exposures between two major counterparties with $500 billion or more in total consolidated assets is strongly supported. It should act to prevent some of the problems associated with interconnectivity. However, adding limits to the amount of short-term debt that may be held by a covered company could work in conjunction with the LCR, NSFR, and the single-counterparty credit limit to ensure we do not have a repeat of the aftermath of the fall of Lehman, where the overnight repo markets froze up and institutions had extensive trouble funding their operations, putting the entire financial system at risk.

Question 25: Should the definition of "counterparty" differentiate between types of exposures to a foreign sovereign entity including exposures to local governments? Should exposures to a company controlled by a foreign sovereign entity be included in the exposure to that foreign sovereign entity?

I suggest that you do not differentiate. It is reasonable to expect that risks at the local and national level can be highly correlated, especially during panics. Differentiating between sovereign and local counterparty risks could result in significant losses arising from such correlations.

Question 26: Should certain credit exposures to foreign sovereign entities be exempted from the limitations of the proposed rule--for example, exposures to foreign central banks necessary to facilitate the operation of a foreign banking business by a covered company?

The history books are littered with failed sovereigns. The European debt crisis is the most recent reminder that sovereign entities are not immune to collapse. Greece in particular concealed its debt woes through complicated currency swaps that artificially inflated their books, which ultimately contributed to the failure of MF Global. Although MFG may not have made the cut as a SIFI its demise illustrates the dangers that exist in being substantially exposed to sovereign debt.

Question 28: Are the measures of "capital stock and surplus" in the proposed rule effective in light of the intent and purpose of section 165(e) or would a measure of "capital stock and surplus" that focuses on tier 1 common equity be more effective? What other alternatives to the proposed definition of "capital stock and surplus" should the Board consider?

The comment letter submitted by Sheila Bair et al suggests using "tangible common equity" and I support this suggestion. The netting of credit exposures, for instance, presents some complications that could be mitigated by using this more conservative measure.

Question 32: Should the Board supplement the net credit exposure limit with limits on gross credit exposure for all covered companies or a subset of covered company, i.e., major covered companies? Explain why or why not.

The Board should consider imposing limits upon gross credit exposure for a given company after reviewing stress tests for that company, during the early remediation process. Applying gross credit exposure limits for all covered companies sounds good in principle. However, it might be more keen to use gross credit exposure limits as a means of de-incentivizing certain forms of credit exposures. That is, the Board should recognize that certain exposures pose a larger threat to the system. The Board could flag certain classes of assets that pose a greater threat to the financial security of the US, and we suspect that the Board will in fact do this since the stress test methods will be updated on an annual basis according to the most recent regulatory concerns. After a stress test reveals that a covered company has an excessive amount of risk related to exposures to such assets, then the Board could impose a gross credit exposure limit on this covered company as a way to mitigate counteparty risks in case the covered company collapses. Moreover, the goal of doing this would be to deter a covered company from concentrating risk that might pose a threat to the financial security of the US, and ideally lead to more effective distribution of risk.

Question 53: What alternative approaches, if any, should the Board consider to capture the risk mitigation benefits of proxy or portfolio hedges or to permit covered companies to use internal models to measure potential exposures to sellers of credit protection?

Portfolio hedges are imprecise and attempts to quantify their risk mitigation benefits are likely to be inaccurate. Permitting proxy and portfolio hedging would give covered companies the means to reduce their credit exposure on paper. Internal models are subject to being rigged in favor of allowing a covered company to expand its risk profile and mischaracterize its true credit exposure.

In other words, proxy or portfolio hedges could result in the hedging of a particular underlying index in such a way that would not hedge against the credit exposure being netted to meet the Rule's requirements.

Question 72: What alternative models or methodologies for estimating a covered company's losses and revenues should the Board consider?

The Board should mandate that covered companies develop reverse stress testing methods to be used during independent stress tests. It is critical that covered companies ritually seek to identify scenarios that would lead to their own demise. Moreover, the collective results from such tests would produce information that could give the Board a view into what assets are collectively regarded as posing the substantial risks to viability, and therefore pose a threat to the financial stability of the US. Many firms may already be conducting reverse stress tests, so the key bridge here is to capture those results so that the Board can find the connectivities that might lead to contagion.

Question 73: What are the benefits and drawbacks associated with company-specific disclosures? What, if any, company-specific items relating to the supervisory stress tests would present challenges or raise issues if disclosed, and what is the nature of those challenges or issues? What specific concerns about the possible release of a company's proprietary information exist? What alternatives to the company-specific disclosures being proposed should the Board consider?

The purpose of the SIFI regulations is to "reduce threats posed by covered companies to the stability of the financial system as a whole." One of the best ways to reduce this threat is if the public and the markets are aware of the threats posed by covered companies. If stress test data is not disclosed, then this essential information is not provided that engenders prudent risk taking. In requiring the promulgation of expansive prudential requirements on covered companies, Congress sent a strong message that the proprietary interests of covered companies are secondary to the safety and stability of the financial system as a whole. Enhanced disclosure is therefore required.

One way to enhance disclosures without revealing "sensitive" information would be to include results of individual model runs where multiple models are used to produce estimated losses for a given class of loans or securities under the proposed scenarios. The NPR says that multiple models will be used but, assuming there is intellectual consistency with the rubric of the most stress test results, it is unclear that the Board will publish results depicting individual model runs. That being said, the bar should be raised from the most recent published results. Providing results about both ensemble characteristics and individual model results would be an example of where a more detailed public disclosure would prevent market distortions, since the results could be better interpreted against the backdrop of model assumptions and a range of outcomes, without divulging specifics relating to a covered company's exposures.

Many industry commentators have suggested that public disclosures could distort market perceptions and therefore in order to avoid this they suggest that the Board should provide a minimal summary of results. The common thread expressed in these concerns seems be that the results will be misread because it might not be clear to market participants that the results express the results of multiple models that are subject to fictitious scenarios. But limiting the detail of results would be an inappropriate solution, and could distort market valuation of covered companies in the inflationary direction. Rather, a nuanced picture that provides a picture about the *range of outcomes* produced from the different model runs would prevent investors from misreading, and misusing, results. That is, using the results of multiple models would require a careful study in order to makes decisions based off of the aggregate findings of those models.

Question 74: What alternative to the public disclosure requirements of the proposed rule should the Board consider? What are the potential consequences of the proposed public disclosures of the company-run stress test results?

The granularity of disclosures should not be reduced. The public disclosures should have at a minimum the level of detail that can be found in the FRB's most recent stress test results, found in the "Comprehensive Capital Analysis Review 2012: Methodology and Results for Stress Scenario Projections." Reducing the granularity of public disclosures could mislead investors and create distorted levels of confidence. The results of the stress test should be viewed as means of facilitating what exists of a price discovery process.

Question 79: The Board also seeks comment on the value of including balance sheet measures, such as nonperforming loans and loan concentrations, in the early remediation regime as triggers. What balance sheet measures, if any, should the Board include, and how should they be calibrated?

For covered entities that engage predominantly in commercial banking, the balance sheet triggers that the Board considered should be included (i.e. nonperforming loans and loan concentration). The case of Washington Mutual's collapse should give ample support for using balance sheet triggers. Before the bank's collapse it made attempts to shore up its distressed balance sheet, which in retrospect was a sign of its imminent collapse. Potential balance sheet triggers should take into consideration asset quality. They could also signal concentration of highly correlated risks, especially in assets that the regulatory community has flagged as posing a risk to the system.

Sincerely,

/s/

Eric Taylor
Member of Occupy the SEC